Attachment 4

Getting up to speed with IFRS

As U.S. companies accelerate toward International Financial Reporting Standards conversion, internal auditors should consider how to prepare for the transition and the role their department might play.

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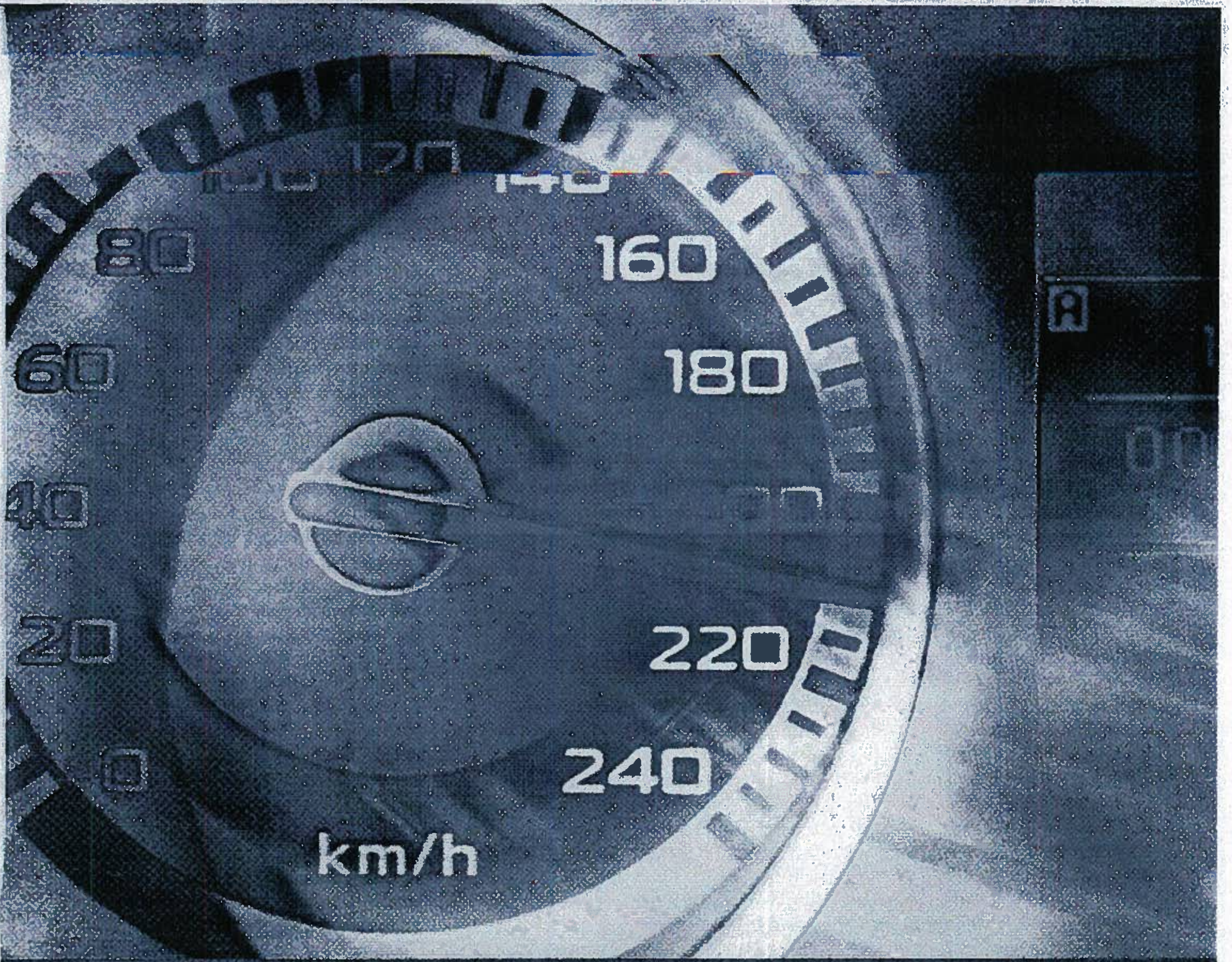
IN A SPEECH HE GAVE TO AN AUDIENCE OF SENIOR FINANCIAL executives this June, John White, director of the Corporate Finance Division at the U.S. Securities and Exchange Commission (SEC), said it was time to face an inconvenient truth: Companies around the world are rapidly migrating to a single set of accounting standards, but they are not U.S. Generally Accepted Accounting Principles (GAAP). Why inconvenient? For years, the idea of a single set of global accounting standards



seemed like an unlikely fantasy, White said. And if accounting rules around the world ever were harmonized, the secret hope was that everyone would adopt U.S. GAAP.

Well, the fantasy has become a reality, but not in the way imagined. Companies around the world have adopted one set of rules, but they are those produced by the London-based International Accounting Standards Board (IASB). More than 100 countries allow or require their companies to use the IASB's International Financial Reporting Standards (IFRS). Others, including Canada and India, are in the process of transition (see "Global Adoption" on this page).

The United States is the only significant player left on the sidelines. But the changeover for U.S. companies could soon be on its way. It's not yet clear what will happen or when, but accounting experts — and internal auditors who have been through an IFRS transition already — say companies should start making plans now.

ON THE HORIZON

Last November the SEC took an historic step in favor of IFRS when it abolished its rule that foreign private issuers had to reconcile their IFRS statements to U.S. GAAP. Now the SEC has published a proposed road map that, if approved, would give the largest U.S. companies the option of moving to IFRS in 2010. Other firms would then be required to use the international standards in three waves. Remaining large firms would switch in 2014, medium ones in 2015, and small ones in 2016. However, the draft road map — which the SEC will vote on after a consultation period that ends in November — allows the SEC to scrap the entire project in 2011 if certain criteria have not been met. These include greater convergence between IFRS and U.S. GAAP, more independence and accountability at the IASB, and better training for U.S. accountants. When the road map was published, SEC Commissioner Elisse Walter stressed that a move to IFRS was by no means definite. "We have to keep in mind that no one knows for certain what the future will hold," Walter said. "I strongly believe that we have to prepare for the alternative that the commission will determine not to adopt, or permit the use of, IFRS for U.S. issuers."

One thing that's clear is that U.S. companies have so far not done much to prepare for this momentous change. White noted in his speech that, for many in U.S. business, the idea of abandoning U.S. GAAP for IFRS was "an idea that seemed so far-fetched it was not worth learning about." That's confirmed by a recent survey from the American Institute of Certified Public Accountants, which found that only 17 percent of its members were actively preparing for a move to IFRS.

But then why should they? "To move forward with such a significant project, companies need a clear understanding of the end requirements before they can develop the necessary systems and procedures and address the critical business issues," says Christine DiFabio, vice president of technical activities at Financial Executives International, a New Jersey based business association for senior financial executives. "It is difficult for most companies to justify major resource allocations or preparatory actions until the key policy makers and regulators provide some firm direction and a timetable to drive the process. Smaller organizations in particular do not have the resources to spend time and money preparing until they feel confident as to the SEC's next steps and requirements."

Global Adoption

More than 100 countries around the world now allow or require their listed companies to produce accounts under IFRS. All of the European Union's (EU's) 27 member states use the standards. Canada and India will be using them by 2011, as will South Korea, with early adoption encouraged from 2009. Japan has pledged to eliminate all major differences between its national standards and all existing IFRS by 2011.

The question of how countries have actually gone about adopting IFRS is a more complicated one, says Patricia O'Malley, director of Implementation Activities at the IASB. A single, universal model for adopting IFRS does not exist, she explains. "Countries have each gone at it in a way that makes sense given their existing framework."

In Europe, for example, the quickest way to implement IFRS was to formally require their use under an EU regulation. But because such a regulation has legal force, the process for formally adopting any new standards is very slow (for example, they have to be translated into every European language first). Sometimes, the EU hasn't been able to adopt a new standard before its application date. This process can cause serious problems for companies with U.S. listings, O'Malley says, because the SEC only exempts foreign companies from producing a U.S. GAAP reconciliation if they use IFRS as issued by the IASB, not IFRS as endorsed for use in the EU.

When it adopted IFRS, the Australian Accounting Standards Board (AASB) decided at first to keep some existing national implementation guidance for issues not covered by IFRS, as long as that guidance didn't conflict with IFRS. This decision caused confusion, as investors weren't sure whether companies were complying with true IFRS, or with an Australian-flavored version. The AASB decided to change tack and delete its national guidance. It now adopts IFRS word-for-word from the IASB's standards.

In Canada, the law requires companies to prepare financial statements in accordance with the standards issued by the Canadian Accounting Standards Board (CASB). "You would think this would mean the CASB could simply issue a standard that said 'follow IFRS,'" O'Malley says, "but apparently that's not good enough." The CASB has to follow its own due process for issuing a standard to include an IFRS in its standards, although like Australia it intends to do so word for word.

SIGNIFICANT CHANGE

While the SEC consults on its proposed road map, companies — and their internal audit shops — can start taking useful action now. They can begin by considering what a large impact the move could have on the company's financials. In terms of what the two regimes say about specific accounting issues, "the devil is in the detail," cautions Andy Davies, a director in the financial reporting advisory team at Ernst & Young in the UK. Different companies will be affected in different ways. For those looking to gain a quick understanding of the likely hot issues for a particular company, he suggests looking at the reconciliations to U.S. GAAP previously published by foreign issuers in the same industry. These statements — which companies no longer publish — highlight the large impact of a shift from one accounting regime to the other.

Last year Citigroup published a report analyzing the reconciliations published by 73 European companies. In total, they made 426 changes to their IFRS accounts to bring them into line with U.S. GAAP. Mostly, the changes related to the treatment of tax, pensions, goodwill and intangible assets, and financial instruments.

These changes had a significant effect on bottom line results. Overall, 82 percent of the companies had higher earnings under IFRS, and 70 percent had a lower balance sheet value. The impact on some companies was startling. Chemical giant Bayer's profits under IFRS were 525 percent higher than under U.S. GAAP. Lloyds TSB, the UK bank, posted IFRS profits 54 percent above the U.S. GAAP equivalent.

Details aside, one fundamental difference between the two regimes will affect all companies. While U.S. GAAP includes detailed rules backed up by application guidance, IFRS is based on principles and is far more open to interpretation.

Consequently, businesses don't just have to change accounting policies, they have to think about accounting — and the controls in place around financial reporting — in a very different way, Davies says. This shift in mentality is the one issue where U.S. companies moving to IFRS really struggle, he says. "All their lives they have been told that there is a rule somewhere, and they just need to find it. Now there are principles instead, which means they have to make a judgment. That is new to people. When you see it in practice, you realize that it fundamentally changes the way people do their jobs."

Indeed, the move to IFRS is much more than an accounting exercise, says John McGaw, a Chicago-based partner in the internal audit, regulatory, and compliance services practice at KPMG. "It will impact a company's systems and processes, internal controls, business practices, and human resource management," he says. A move to IFRS might require a wider company rethink that encompasses internal controls, IT systems, cash management, income taxes, contractual arrangements, and compensation plans.

All these factors can make a transition to IFRS a tortuous project. The one big lesson that U.S. companies can learn from foreign businesses that have adopted IFRS already is to fully appreciate the effort involved, says Sam Doolittle, a global IFRS partner at Deloitte & Touche in San Francisco. Many companies underestimated the work and left their planning too late.

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WORKING WITH THE BOARD

With companies facing such a big change, their internal audit shops have an important role to play, DiFabio says. "They should be making sure not only that all of the necessary accounting and IT changes are being considered, but that other factors and impacts are taken into consideration too," she says. "Internal auditing should be there to assist and challenge the process and make sure the company is doing everything it should be. The announcement of the SEC's proposed road map now provides companies with a time line they can plan toward."

Conducting a high-level review to assess how IFRS would affect the company can serve as a useful starting point, and internal auditing can play an important part in this process, Davies says. Auditors can use the results of this review, he adds, to educate the board about the impact of an IFRS switch. The board needs to become familiar with IFRS-related issues early in the transition process, he says. Not only do board members need to know what is going on, but they need to communicate that clearly to stakeholders — especially investors.

Next, the board needs to decide its IFRS strategy, Davies says. "Rushing into an IFRS conversion without clearly thinking through the strategy for adopting it is dangerous," he argues. "It could lead to a lot of inefficiency, where one route is taken and the board realizes halfway through that it has gone down the wrong path."

What kind of strategic options does the board have? Davies identifies two. The first is to take what he calls "the easy ride" — continuing to follow U.S. GAAP as much as possible and only making the accounting changes that are required. This approach has the benefit of minimizing disruption. The second is to take a fresh start — using the move to IFRS as an opportunity to adopt different accounting treatments.

The board also has to make another call: How quickly should the company adopt? "Do we want to adopt early, or do we want to wait and see what everyone else does, and what accounting options other people in our industry embrace?" Davies asks. Companies that adopt early might be able to enhance their reputation for good financial reporting, but they run the risk of finding themselves out on a limb if their peers adopt different accounting treatments.

EARLY INVOLVEMENT

McGaw stresses the need for internal auditing to get involved early in the transition process. With its helicopter view of the organization, the audit shop is well-placed to understand the wider impact of

IFRS conversion. But there is no fixed role for internal auditing, he says — it depends on the needs of the company, and what kind of work internal auditing does already. If the shop already has a significant role in strategy, financial reporting risk, and accounting policy matters, it should expect to be heavily involved in the transition to IFRS, McGaw says.

Internal auditors also need to consider the impact that IFRS adoption could have on their own shop, McGaw says. Chief audit executives (CAEs) should begin thinking about the level of audit resources needed to support their company's implementation of IFRS, as well as specific skill requirements. "Seek to establish a position on the company's IFRS steering committee and formulate a plan to address internal audit resource and training gaps that may result from the IFRS conversion," McGaw advises.

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Davies also highlights the resource issue. "You need to have enough people on the finance team and on the internal audit team with the right knowledge to perform the transition and to use IFRS on a day-to-day basis," he says. Demand will be strong for people with technical knowledge of the standards, "But I think it's more important to have the practical experience of how to go through an IFRS conversion."

U.S. GAAP vs. IFRS

The move from U.S. GAAP to IFRS represents a significant project, but the two regimes have more in common than people tend to think, accounting experts say, as both are built on the same set of basic principles. However, there are important differences, and published reconciliations from IFRS back to U.S. GAAP show big moves in profits and balance sheet values.

"Some issues will require only minimal effort to make the change from U.S. GAAP to IFRS, while others may require significant changes to business and financial reporting processes," says John McGaw, a partner in the internal audit, regulatory, and compliance services practice at KPMG in Chicago. Areas where U.S. companies could see significant changes include impairment of long-lived assets and investments, revenue recognition, classification of instruments as debt or equity, and consolidation. "Even in areas where the standards are very similar, such as share-based payments, post-retirement benefits, business combinations, and income taxes, there are often unexpected differences waiting in the application of the standards," McGaw says.

Accounting experts say the biggest difference between the two regimes is that U.S. GAAP provides rules backed up by detailed guidance, whereas IFRS is more principles-based. "U.S. GAAP provides a safe harbor for companies and auditors," says Scott Bressler, managing director of FTI Seminars. "If you follow all of the U.S. standards, you can safely give an opinion that says the financial statements are fairly presented. Under IFRS, due to the lack of detailed guidance, that doesn't work. You have to look at the final result taken as a whole (i.e., all of the financial statements and the disclosures) to determine if they represent a true and fair view. I don't think most people in the United States realize this yet."

In a litigious country like the United States, "companies like the fact that they can say they have done an audit, followed the standard, and can leave it at that," Bressler says. "They don't have to stand back six feet and ask, 'Does this really make sense?'"

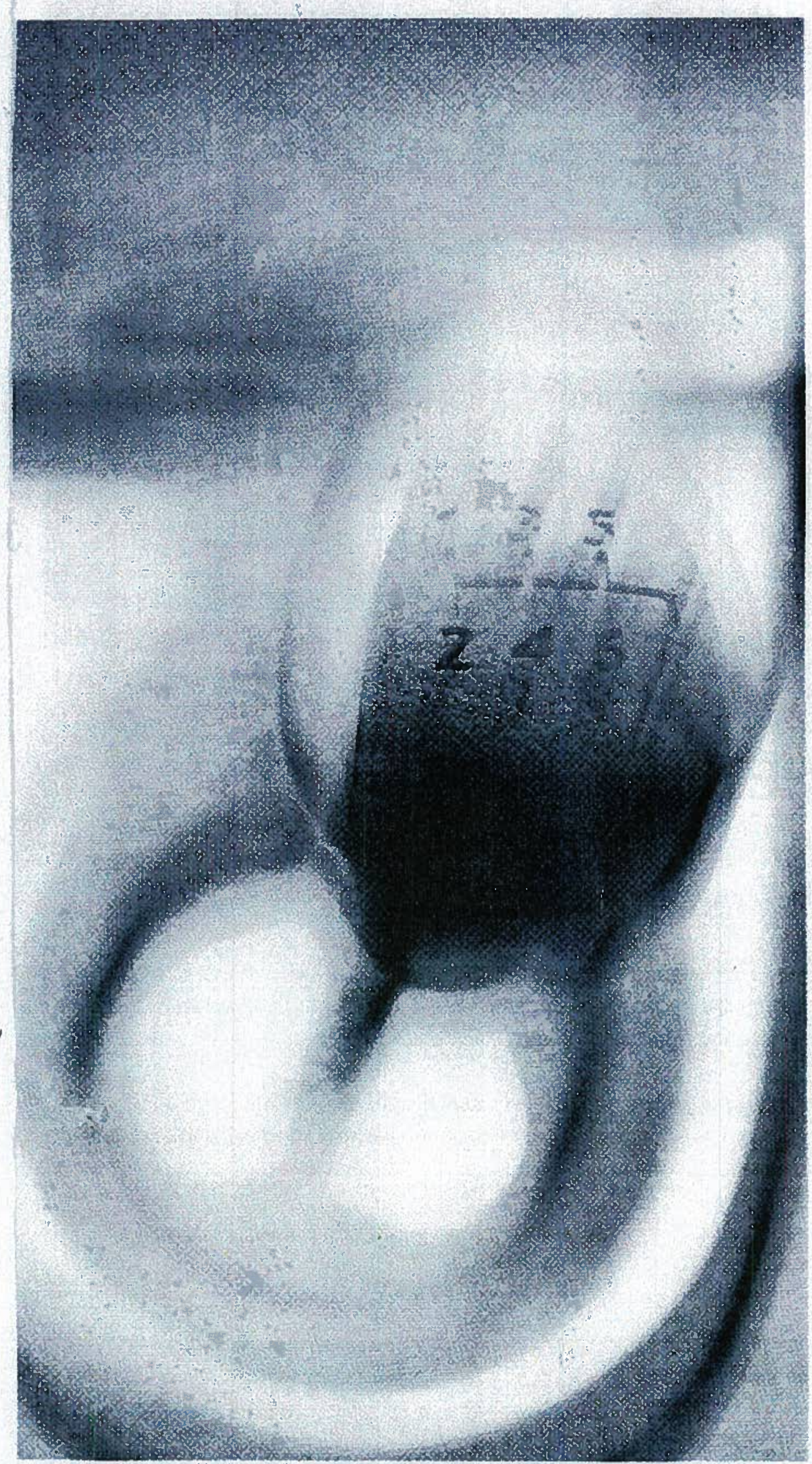
LESSONS LEARNED

What are the lessons from internal auditors who have been through a transition already? If the audit function wants to get heavily involved in the transition, it must avoid running the project, says James Grigor, head of internal audit at the UK-based global telecommunications company BT — that should be a management responsibility. At BT, internal auditing had limited involvement in the move, Grigor says: "Our external auditors wanted to take a strong lead on the project, because of their responsibilities regarding our financial reports."

The internal audit shop played a high-level role at UK-based pharmaceuticals company AstraZeneca, explains James Paterson, vice president of group internal audit. "The key is to have the right team leading the IFRS project," he says. "If there is a high-quality project team, with the time and resources to work through the key areas affected by IFRS, the right quality assurance processes in place, and strong executive support, internal auditing can safely take a high-level role.

His other tips for IFRS success: Make sure the company puts aside the time and resources it will need to gather the information for prior-year restatements, ahead of the "go live" year, he says. "But most of all, it's important to keep close to your external auditors. Get sign-offs from them on key points throughout the process."

The finance team took the IFRS lead at Electrocomponents, a UK company that supplies engineering parts, says Paul Kaczmar, its head of operational audit. The project started with a high-level review of the likely impact of IFRS, which identified three significant changes and five of medium impact, he says. "They then did a road show to communicate those results to all of the operating groups, and to us in internal auditing." The company then set up a project team to drive the transition, with its external auditor auditing IFRS compliance and the achievement of project milestones. "I essentially reviewed that approach and kept a watching brief to make sure those key components were being delivered," he says. Kaczmar monitored whether the project had enough resources, whether the communications were effective, and whether the external auditors and the finance team were keeping the audit committee informed on progress. "If at any stage in the process



I wasn't happy about the progress of the project, then I had the opportunity to speak up," he says.

What would he be doing now, if he were CAE at a U.S. company? "I wouldn't start a transition project yet, as it's still not certain what will happen or when," he says. "But I would want to see a review of which areas of the business would be affected by IFRS and whether the impact would be high, medium, or low. Then I'd want a high-level time line, with a few key milestones so that we could determine, for example, when we would need to begin addressing high-impact areas."

Kaczmar would then ask his external auditors to review that assessment. The key question? "At this moment in time, do you have any other information or an understanding of our business that suggests this will take longer than we think?" he says.

What would Paterson be doing about IFRS if he were leading a U.S. audit shop? "I'd keep up the dialogue with my peers and external sources around the likely way forward and consider carrying out an early high-level impact analysis," he says. "I'd also look at the amount of IFRS knowledge in my company — if there isn't a lot, I'd enlist key accounting and audit staff members to conduct training courses. I'd also start thinking about potential candidates for a competent project team — I'd look for a mix of strong project management skills as well as IFRS expertise."

Audit shops can't do much more, says Scott Bressler, managing director of Rockville, Md.-based FTI Seminars, which trains companies and auditors in GAAP and IFRS. "We really don't have enough information yet, so I think it is too early to start worrying," he says. "There is still too much of a possibility that a move to IFRS won't happen."

Ernst & Young's Davies cautions that IFRS is still developing, and will continue to do so. "It's good to plan early, but my warning would be that doing too much too early might be a bad idea," he says. However, that's not a license to do nothing. "This is a good opportunity for internal auditing to make a real difference and to push the board and the finance team to be ahead of the curve," he says.

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